

APPENDIX

Notes for FOMC Meeting

August 12, 1980

Scott E. Pardee

In the five-week period since the July 9 FOMC meeting, market sentiment toward the dollar has improved--albeit in fits and starts--and exchange rates for the dollar are now generally higher. The dollar is up by some 2-1/2 percent against the German mark and the other EMS currencies, 1/8 percent against sterling, and 2-1/2 percent against the yen. Although we intervened on several occasions when the dollar came under selling pressure, on balance the Desk acquired sizable amounts of marks and some Swiss francs from correspondents and in the market. These operations enabled the System to repay some \$460 million equivalent of swap debt to the Bundesbank.

This improved atmosphere for the dollar has stemmed from a combination of factors here and abroad. News on the real economy heartened the market. The trade deficit for June, at \$2.3 billion, was again much better, confirming expectations that we are in a trend towards surplus in the current account, if not in the second half of 1980 at least by early 1981. Release of the latest leading indicators, showing a rise of 2.5 percent in June, prompted a burst of dollar bidding on the view that the economy may not be contracting as rapidly in the third quarter as it did in the second quarter. Several other straws in the wind have given hope that the recession would not be as deep or prolonged as many had feared. In addition, market participants felt that the less precipitous decline, if not a bottoming out of the domestic economy, would reduce some of the pressure on the authorities to take stimulative action, which would endanger the fight against inflation.

In this light, the Administration's efforts to head off an early tax cut were somewhat reassuring. And, Chairman Volcker's July 22 testimony, outlining the System's targets for the rest of this year and views for next year, was well received. The 1981 targets embodied in Chairman Volcker's subsequent letter and the Senate Banking Committee's published report this past weekend, strongly in support of the Federal Reserve's anti-inflation approach, have also generated favorable comment in the market.

Indeed, those in the exchange market who had been betting against the dollar on the view that the Federal Reserve would be pressed into easing have had a bad time of it in recent weeks. The shorts have been burned repeatedly as the monetary aggregates have continued to come in fairly strong and as short-term interest rates have firmed. In this context, the market accepted the Federal Reserve's full percentage point cut in the discount rate on July 25 as a technical correction, and cumulative selling pressure on the dollar did not develop. This does not mean that the exchanges are any less sensitive to movements in market interest rates. The dollar still has a tendency to decline each time the federal funds rate eases, even over the course of a given day.

Looking abroad, the economies of major countries seem to be cooling rapidly, although only the U.K. and Canada are clearly in recession. Slower growth will help reduce some of the massive current account deficits being racked up by most countries in continental western Europe and Japan, but again the market's immediate focus remains on monetary policy and the outlook for interest rates. During the period, several major central banks moved gingerly away from their restrictive stances of earlier in the year. Early in August the Bundesbank began to inject additional liquidity in the money market, and although the amount of marks created was modest, the action was accompanied by an explanation by President Poehl that this was a slight easing of policy. Short-term interest rates in Germany have in fact declined a little. At about the same time, the Bank of France quietly lowered the interest rate at which it intervenes in the domestic money market. By contrast, the U.K. authorities have not been able to reduce MLR further, mainly because the removal in June of the corset on the growth of banks' liabilities was followed by an unsightly bulge in the growth of sterling M3. It grew 5 percent for the month of July, or 60 percent at an annual rate. The Japanese authorities are still holding firm but the market expects some easing of rates soon. In any event, any easing by foreign central banks is expected to be modest, in view of their concerns about domestic inflation and the need to promote capital inflows to finance current account deficits. For the same reason, foreign central banks will be pretty quick to support their currencies should the dollar strengthen very much in the exchange markets.

Early in the period we intervened on several occasions in marks, French francs, and Swiss francs when the dollar came under selling pressure. Since late July the Desk has moved to acquire marks whenever we could, either through transactions with the Bundesbank, as we have in the past, with European central banks including those that have bought marks in EMS operations, or in the market at times when the dollar was buoyant. As indicated at the outset, we repaid a net of \$460 million of mark swap debt, leaving the total at \$683 million. The Treasury is sharing in most of these acquisitions, and although it added more than \$200 million equivalent to balances during the period, it still needs some \$3 billion equivalent to fully cover its mark indebtedness under the Carter notes. We also acquired some \$197 million of Swiss francs for the System and the Treasury balances. With the French franc remaining strong in the EMS, we have not as yet acquired more than nominal balances against our swap debt with the Bank of France.

REPORT ON
OPEN MARKET OPERATIONS

Mr. Sternlight made the following statement:

The Desk pursued its reserve paths since the last meeting of the Committee against a drumbeat of restlessness and uncertainty in the financial markets. Initially, it looked as though aggregates were growing about on track. As the Desk met path needs for reserves, the market searched, and sometimes imagined it had found, clues of an easier policy stance. Some early strengthening of the aggregates and of reserve needs was accommodated by small upward revisions in the path but a point was soon reached where further accommodation was not deemed appropriate--in light of the appreciable strength in M_{1B} and, even more, the great strength in M_2 . The strength of M_2 was also a modest background factor in making judgments about the extent and timing of technical adjustments to the path.

The further strengthening in aggregates appeared in our path formulations to produce only a slightly increased need for adjustment borrowing, but the combination of this slightly increased need along with a large bulge in demand for excess reserves produced a considerable firming in the money market in late July-early August. This sent the Federal funds rate up from its flirtation with the Committee's 8 1/2 percent lower bound to around the 10 percent area or above briefly, while adjustment borrowing rose from roughly \$100 million area to averages around \$400-500 million in the weeks of July 30 and August 6.

As a result, some members of the army of Fed watchers quickly swung from near-certainty in mid-July that the System was

easing to an equally firm conviction that a tightening was under way--a thesis they sought to support with evidence from weekly money aggregates and some business indicators that appeared during the interval. Other observers were not so quick to draw conclusions but nevertheless they experienced enough uncertainty or confusion to contribute to a series of skittish market reactions and counter-reactions. For a series of days, it looked as though the content and timing of every Desk action was instantly analyzed, and typically misinterpreted, and some observers turned with nearly equal fervor to analyzing the absences of Fed action when they expected something to be done.

In the last few days the money market has been steadier, with Federal funds hovering around 9 percent and adjustment borrowing back down to the low levels that preceded the late July rise. The very high level of excess reserves in the last two full weeks remains something of a puzzle. Conceivably, since the high excess emerged in the week that the recent large reduction in reserve requirements took effect, the excess may reflect a lag in employing some of those released reserves, but we don't really know. So far this week, it looks like a more normal level is emerging.

A constructive result of the recent gyrations in sentiment, as analysts sought to overinterpret System intentions and Desk actions, is that market participants seem to have learned--for a while at least--that the Federal Reserve really meant it last October when it was stated that there was less emphasis on the funds rate and that funds could move over a considerable band without it having great policy significance. However, I can think of better times to try to put

this lesson across than a quarterly Treasury refunding period-- it has given the market, the Treasury, and ourselves some trying moments.

As for achieving our paths, it looked as of last Friday as though total reserves might average about \$160 million above path for the five-week average, while nonborrowed may come out very close to path. The overrun on total reserves can be related on the one hand to the high average level of excess reserves, and on the other hand to higher average adjustment borrowings than were incorporated into the initial path.

Operationally, the main thrust of Desk activity during the period was to drain the reserves released by the roughly \$3 1/2 billion reduction in required reserves effective July 24. Some \$875 million of bills were sold on the market that day, while on that and other days nearly \$1.4 billion of bills were sold to foreign accounts and \$950 million were redeemed in auctions. The total decline in outright holdings was thus about \$3.2 billion. There were no outright purchases during the period. Short-term injections and withdrawals of reserves were used to cope with temporary swings in reserve availability.

Over the next week or two we expect to have a need for outright reserve additions, some of which could probably be met in the coupon area. Before too long, though, we'll be having to look ahead to the large need for reducing the System's holdings again when phase-in of lower reserve requirements begins.

Market interest rates backed and filled over the recent period, but ended up higher on balance. Aside from the gyrations

in sentiment mentioned earlier, in response to Desk moves and funds rate variations, there was an underlying caution in response to perceptions of greater Treasury and private sector demands for funds, reinforced by reports suggesting that the recession could be less deep and shorter-lived than had been anticipated a month or so earlier. Price news remained discouraging. The markets also took note of Chairman Volcker's testimony, which underscored the System's determination to stay the course with an anti-inflation program, and in particular not to press reserve growth aggressively over the rest of this year merely to assure that the narrow aggregates make up for slow growth in the first half. The discount rate reduction announced July 25 was accepted as "purely technical" and elicited virtually no market reaction.

Treasury bill rates have risen about 65-100 basis points over the period. Three- and six-month bills were auctioned yesterday at about 8.72 and 8.89 percent, respectively, compared with about 8.21 and 8.11 percent shortly before the last meeting. The Treasury was continuing to add to bill supplies steadily during the period while, as noted, the System cut its bill holdings.

In the intermediate term area, Treasury yields rose about 80-125 basis points while rates were up 80-100 basis points at the long end. The Treasury raised over \$4 billion in coupon issues during the period, much of it in the quarterly refunding issues sold last week for August 15 settlement. Given the uneasy sentiment in the market during the auction period, investors shied away and dealers were left to take down large shares of the new issues. There has been some distribution since the initial take-downs but dealers

still have very large holdings--a total of \$4 billion in over-one-year maturities, compared with about \$1.8 billion at the time of the last meeting. Dealers took on their holdings only after exacting further price concessions, in view of present uncertainties, but their holdings of new issues are all under water now. If retail distribution picks up, the dealers may not fare too badly, and indeed some hope to see prices rise as distribution proceeds, but if investors hold back, the overhang of inventories could contribute to a further push up in yields.

James L. Kichline
August 12, 1980

FOMC BRIEFING

Recent information indicates that the rate of decline in economic activity is slowing, following the huge drop during the second quarter. In large measure, developments in housing markets and in consumer expenditures are responsible for the improvement.

In housing markets, the reduced cost and greater availability of mortgage credit has been the key element influencing the increased level of activity in recent months. Sales of new homes increased in June after a strong advance in May. Housing starts and permits also rose vigorously in June and early reports indicate another strong rise in residential building permits in July. Permits, starts, and home sales still are quite low, however, and our forecast suggests that the housing market recovery will be moderate compared with past cyclical experience, in part owing to financial constraints.

Consumer outlays rose in both June and July following four months of substantial declines in retail sales in both nominal and real terms. The upturn in total retail sales during the past two months was fairly widespread, but auto sales were the significant element in the turnaround--especially in July. Sales of foreign and domestic models reached a 9 million unit annual rate, still low but up considerably from the unusually depressed rates in the spring. To some extent July auto sales were bolstered by sales incentive programs and probably by the removal of the credit restraint program as well. The absence

of such special forces could well make it difficult in the next couple of months for auto firms to match the July performance. Even so, it appears likely that we've seen the worst in terms of auto sales and production.

Consistent with an apparent bottoming-out of the housing and auto markets, production in related areas appears to have leveled off in July or increased. These sectors--such as lumber and steel--helped limit the drop in total industrial production. The industrial production index for July will not be available until later this week, although available information indicates it fell by somewhat less than the 2.4 percent in June. Nonetheless there seem to have been further sizable declines in machinery output and in production of some nondurable goods. The capacity utilization rate for manufacturing in July dropped further, probably falling below 75 percent or roughly 12 percentage points below its 1979 peak.

In labor markets, the two major employment series pointed in different directions last month, as sometimes happens, but a number of points are clear. One is that there was less weakness in employment demand in the aggregate than during other recent months, with trade and service employment actually growing significantly. Another is that the industrial sector showed a further substantial decline in employment; manufacturing jobs were cut another quarter million, and the workweek--a fairly reliable lead indicator--remained extremely low.

In part the drop in manufacturing employment and in production undoubtedly reflects the continued weakness in business capital spending. Shipments of nondefense capital

goods in nominal terms fell in June and for the second quarter as a whole were off 2.7 percent--the sharpest drop since the data were first collected in 1968. And the outlook for capital outlays continues poor. New orders for nondefense capital goods were off 10 percent in real terms in the second quarter, with machinery orders down even more. Little growth is expected in nonresidential construction spending since these contracts generally have moved lower since the beginning of the year.

The continued contraction of industrial production and employment also reflects a relatively successful effort by business to curb the further backup of stocks. Business inventories in constant dollars were reduced in May following the sharp April rise, and the figures for June also suggest little accumulation at most.

Given the likelihood of somewhat less stock liquidation than had earlier appeared necessary as well as the stronger-than-expected recent data on housing and consumption, the staff is now projecting a somewhat smaller decline than last month in economic activity for the third quarter--about a 4 percent drop at an annual rate. But with capital outlays continuing to contract, the recovery in housing constrained by high interest rates and consumer spending damped by uncertainty regarding employment and income prospects, we do not expect a decisive upturn in overall activity before year-end. The cumulative decline in real GNP from peak to trough is now estimated to be about $3\frac{1}{2}$ percent, about three quarters of a percentage point less than last month.

The forecast continues to show a sluggish recovery in 1981. Even with the assumed tax cut of \$28 billion, discretionary fiscal policy is believed to be a restraining force along with monetary policy. Real GNP is projected to rise by about $2\frac{1}{2}$ percent over 1981, and the unemployment rate is expected to edge down during the year, but still be in the $8\frac{1}{2}$ percent rate in the fourth quarter.

Unfortunately, little progress in slowing inflation is expected despite the high rates of unused physical and labor capacity. And there seems slight hope for any improvement for the balance of this year. Price increases have eased recently, largely as a result of a considerable slowdown in energy prices and some moderation in food prices. But assistance from these sources is not likely to continue--especially with the recent adverse weather affecting food supplies--and prices as measured by the gross business product fixed weight index are expected to rise somewhat more rapidly--at about a $9\text{-}3/4$ percent rate--in the latter half of this year. We do anticipate that price increases will ease in 1981 in an environment of continued severe underutilization of resources--with the index slowing to an $8\frac{1}{2}$ percent pace by the end of next year. It is difficult to envision much greater progress against inflation in this time period, given the likelihood of continued large increases in unit labor costs and high rates of food and energy inflation.

August 12, 1980

FOMC BRIEFING - Edward C. Ettin

As noted in the Bluebook, the evolving patterns in the monetary aggregates suggest that M-1A growth over the QIV '79 to QIV '80 period is likely to be near the low end, M-1B near the midpoint, and M-2 at--or perhaps even above--the upper bound of their respective long-run ranges. The divergence among these growth patterns raises difficult questions for the Committee's review of its short-run targets.

Alternative A retains the Committee's 7 percent minimum M-1A target for June to September, a target which the Bluebook notes would imply growth of M-1B, and especially of M-2, above their 8 percent targets for the third quarter. Alternative B is designed to begin moving M-2 closer to its short-run target in order to increase the probability that this aggregate will finish the year within its longer-run range. The relationships are such, however, that the staff believes a sharp increase in interest rates would be required to reduce M-2 growth significantly over the remainder of the year. And such a reduction would cause M-1A growth to slow further, increasing the probability that this aggregate would fall below its longer-run target.

In choosing between alternatives A and B--or even evaluating a more restrictive policy designed to lower M-2 growth significantly this quarter--the Committee may be aided by consideration of the major factors that appear to be affecting the growth patterns of each of the aggregates.

The recent stronger growth of the narrow money measure appears to reflect the pick-up in nominal spending, the earlier declines in interest rates, and a firming of the demand for cash balances after unusual weakness in the second quarter. Even with the pick-up in its growth, M-1A has not yet returned to the lower bound of its longer-run range. In short, the narrow money measure does not appear to have been expanding recently at a surprising rate, but rather at a pace consistent with the expected and targeted patterns. However, the GNP projection implies that maintaining the present 7 percent or so target for the balance of the year--which would result in 4 percent growth for the QIV '79 to QIV '80 period--would be associated with some further rise of interest rates later this summer and into the fall. The alternative B pattern, which further restrains M-1A growth, would imply still higher interest rates than assumed for the staff GNP forecast.

The relatively stronger growth of M-1B had, of course, been expected in light of the public's shifts to ATS/NOW accounts, but the differential in the growth rates between M-1A and M-1B since May has been somewhat larger than previously thought likely. However, growth in M-1B may have been boosted in the last couple of months by the surprisingly sharp expansion of savings deposits. Since both ATS and passbook accounts have the same ceiling rate, it is quite unlikely that bank customers have separate ATS and savings accounts; a more than normal amount of the growth in "pure" savings deposits may consequently have been captured in the ATS measure. Our projection that savings account growth will slow thus implies a narrowing gap between the rates of expansion of M-1A and M-1B in the months ahead.

In evaluating the tendency of M-2 to run at or above its longer-run range, it may be of interest to the Committee that M-2 is behaving quite similarly to previous periods when interest rates declined--such as in 1975-76, 1970-71, and 1967. By contrast, in presenting to the Committee the options for the longer-run ranges early this year, the staff had assumed that the MMC and the MMMF--which either did not exist or were relatively unimportant in previous cycles--would greatly moderate the interest elasticity of M-2. That is to say, we expected that as interest rates changed shifts among assets captured in M-2 would dominate shifts between M-2 assets and non-M-2 assets. Over the interest rate cycle more stable growth in this aggregate relative to income was expected to result. If that expectation was shared by the Committee, and was in fact incorrect, the M-2 target has been misspecified and larger M-2 growth would be consistent with the same degree of restraint previously assumed to be associated with a lower pace of expansion of this aggregate.

Even if there was no misspecification initially, it is also possible that the behavior of M-2 this year may reflect some unusual shifts in the composition of the public's holdings of financial assets. For example, large denomination MMMF shares have been unusually strong in the last few months, perhaps reflecting substitution out of the declining volume of bank CDs. In addition, although moderating most recently, savings bond attrition has been extraordinarily large this year, and it is reasonable to assume that a significant portion of these funds were re-invested in M-2 type assets. Moreover, the recent adjustment in the ceilings for floating rate deposits has probably made these instruments relatively more attractive. And, finally, the uncertainty about the

interest rate outlook may have induced a temporary shift of funds from market securities to such liquid assets as MMMF shares or even savings deposits.

Such shifts between assets that are not in M-2 to those that are in M-2 do not, it seems to me, imply a more expansionary monetary policy, but rather a shift in the public's asset preferences in reaction to events. If this view is correct, efforts to slow M-2 growth in order to counter such a change in asset preferences could result in more policy restraint than may be desired by the Committee.